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QUALIFIED EQUITY AND SUBORDINATED DEBT INVESTMENTS TAX CREDIT

**23 VAC 10-110-225 Qualified Equity and Subordinated Debt Investments Tax Credit.**

23 VAC 10-110-225 Qualified Equity and Subordinated Debt Investments Tax Credit;  
Definitions.

The following words and terms, when used in this regulation, shall have the following meaning, unless the context clearly indicates otherwise:

"Affiliated" means a direct or indirect ownership interest of at least 80% in an entity.

An indirect ownership interest includes, but is not limited to, direct ownership interests held by a taxpayer's family members or an entity affiliated with such taxpayer and/or family members, or any combination of these.

"Equity" means common stock or preferred stock, regardless of class or series, of a corporation; a partnership interest in a limited partnership; or a membership interest in a limited liability company, any of which is not required, or subject to an option on the part of the taxpayer, to be redeemed by the issuer within five years from the date of issuance.

"Family member" means, when applied with respect to a taxpayer, (i) a spouse; (ii) children; (iii) grandchildren; (iv) parents; (v) spouse's parents; and (vi) grandparents.

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"Primarily engaged in business in the Commonwealth" means 50% or more of the entity's gross receipts are derived from sources within Virginia.

"Qualified business" means a business which (i) has annual gross revenues of no more than five million dollars in its most recently completed taxable year, (ii) is commercially domiciled in the Commonwealth, (iii) is primarily engaged in business or does substantially all of its production in the Commonwealth, and (iv) is not primarily engaged, or is not primarily organized to engage, in any of the following types of businesses:

1. Banks;
2. Savings and loan institutions;
3. Credit or finance;
4. Financial, broker or investment;
5. Businesses organized for the primary purpose of rendering professional services as defined in Chapter 7 (§ 13.1-542 et seq.) of Title 13.1;
6. Accounting;
7. Government, charitable, religious or trade institutions or organizations;
8. Conventional coal, oil and gas, and mineral exploration;
9. Insurance;

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10. Real estate design or engineering;
11. Construction or construction contracting;
12. Business consulting or business brokering;
13. Residential housing, real estate brokerage, sale or leasing businesses, or real estate development; or
14. Any business which is in violation of the law, and such others as the Department of Taxation may designate.

A business in its first taxable year of operations will be deemed to have annual gross revenues of no more than five million dollars and be primarily engaged in business and do substantially all of its production in the Commonwealth if the commercial domicile pursuant to 23 VAC 10-120-140 of such business is within the Commonwealth.

"Qualified investment" means a cash investment in a qualified business in the form of equity or subordinated debt. An investment shall not be qualified, however, if the taxpayer who holds such investment, or any of such taxpayer's family members, or any entity affiliated with such taxpayer, receives or has received compensation, as defined in § 58.1-302 of the Code of Virginia, from the qualified business in exchange for services provided to such business as an employee, officer, director, manager, consultant, independent contractor or otherwise in connection with or within one year before or after the date of such investment. For purposes hereof, reimbursement of reasonable expenses

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incurred shall not be deemed to be compensation. A qualified investment shall not include existing investments or instruments that have been purchased, transferred, or otherwise obtained without providing new capital to a qualified business.

[A subordinated debt instrument that is convertible into equity would qualify if (i) the subordinated debt would otherwise meet the definition under this section, (ii) the equity would otherwise meet the definition under this section, and (iii) the subordinated debt does not include a provision by which the issuer may compel the conversion into equity before the end of the required holding period of the subordinated debt.]

An investment which would otherwise qualify for this credit will not be allowed if 50% or more of the proceeds resulting from the investment are used within one year of the cash investment to retire or reduce debt or equity of a qualified business that was incurred prior to the investment.

"Subordinated debt" means indebtedness of a corporation, general or limited partnership, or limited liability company that (i) by its terms requires no repayment of principal for the first three years after issuance; (ii) is not guaranteed by any other person or entity, or secured by any assets of the issuer or any other person or entity; and (iii) is subordinated to all indebtedness and obligations of the issuer to national or state-chartered banking or savings and loan institutions. [Except as provided for under 23 VAC 10-110-229, any transaction that results in the extinguishment or to reduction of outstanding

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principal of a subordinated debt instrument used to qualify for this credit shall be deemed as a repayment of principal. Such transactions, include, but are not limited to:

1. Reacquisition, retirement, or cancellation of a qualified investment,
2. Refunding or refinancing of a qualified investment by new issues of debt, or
3. Exchange of a qualified investment for common or preferred stock.]

"Substantially all of its production in the Commonwealth" means 80% or more of the entity's expenses are incurred within Virginia.

23 VAC 10-110-226 Qualified Equity and Subordinated Debt Investments Tax Credit;  
General Credit Provisions.

A. For taxable years beginning on or after January 1, 2001, a taxpayer shall be allowed a credit against the taxes imposed by Articles 2 (Individual Income Tax; § 58.1-320 et seq.) and 6 (Taxation for Estates and Trusts; § 58.1-360 et seq.) of Chapter 3 of Title 58.1 of the Code of Virginia in an amount equal to 50% of such taxpayer's qualified investments made during such taxable year.

B. The aggregate amount of the credit that may be used by any taxpayer per taxable year shall not exceed the lesser of (i) the tax imposed for such taxable year or (ii) \$50,000.

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The credit is not refundable and may not be carried back. Any credit, or portion thereof, not usable for the taxable year in which the credit was earned may be, to the extent allowable, carried over for the next fifteen succeeding taxable years or until the total amount of the tax credit earned has been taken, whichever occurs first.

C. The total amount of tax credits available for the Commonwealth's fiscal year shall not exceed \$5 million. In the event that the total eligible credit requests exceed the Commonwealth's annual fiscal limitation, each taxpayer shall be granted a pro rata amount as determined by the Department of Taxation. The amount of such prorated credit shall be determined by multiplying a fraction, the numerator of which shall be the credit requested by the eligible taxpayer for such year, and the denominator of which shall be the total credits requested by all eligible taxpayers for such taxable year, by the Commonwealth's annual fiscal limitation of \$5 million.

D. The amount of any credit attributable to a qualified investment by a partnership, electing small business corporation (S corporation), or limited liability company shall be allocated to the individual partners, shareholders, or members, as they may determine.

The limitation in ~~[subdivision subsection]~~ B (ii) of this section shall be construed to allow individual partners, shareholders, or members to each claim annual credits of \$50,000.

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23 VAC 10-110-227 Qualified Equity and Subordinated Debt Investments Tax Credit;  
Qualified Business Application Procedure.

A. Every eligible entity desiring to be designated as a qualified business for purposes of this tax credit must make an application on the Application for Designation as a Qualified Business for the Qualified Equity and Subordinated Debt Investments Tax Credit to the Department of Taxation. Such application must be made prior to the issuance of any equity or subordinated debt; otherwise, the issuance shall not qualify for the tax credit, except as provided in paragraph B below:

1. A qualified business application must be made at least 90 days prior to the issuance of any equity or subordinated debt to ensure that the Department of Taxation's determination regarding the entity's qualification will be made prior to the issuance date.

2. A qualified business application may be made less than 90 days prior to the issuance of any equity or subordinated debt; however, the Department of Taxation cannot ensure that its determination regarding the entity's qualification will be made prior to the issuance date.

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B. A qualified business application will not be accepted after the issuance date of any equity or subordinated debt, except in the following instances:

1. Issuances of equity or subordinated debt made in calendar year 2001, between January 1, 2001 and before September 1, 2001, for which qualified business applications must be made by October 1, 2001;

2. Issuances of equity or subordinated debt made on September 1, 2001 and before January 1, 2002, qualified business applications must be made prior to the issuance date as described in subdivisions A 1 and A 2 of this section. (For example, issuances made on September 1, 2001 and before January 1, 2002 will require a qualified business application no later than June 1, 2001, to ensure that the Department of Taxation's determination will be made prior to the issuance date); and

3. Issuances of equity or subordinated debt made on or after January 1, 2002, but within three months of the end of the most recently completed taxable year of the qualified business. For such issuances, the application must be made by the first business day of the fourth month following the end of the most recently completed taxable year.

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C. The entity seeking designation as a qualified business shall make application by completing and submitting the Application for Designation as a Qualified Business for the Qualified Equity and Subordinated Debt Investments Tax Credit to the Department of Taxation.

D. If the Department of Taxation determines the entity is a qualified business, the Department of Taxation shall issue a certification to the entity stating the same. Such designation shall be valid only for the calendar year of issuance.

E. Upon issuance of equity or subordinated debt to taxpayers, the qualified business shall issue a statement to each taxpayer for attachment to the taxpayer's tax credit application. Such statement shall contain the following information:

1. The qualified business certification granted by the Department of Taxation.
2. The type of investment at issue (i.e. equity or subordinated debt) and the amount.
3. That the investment at issue meets the definition of a qualified investment for purposes of this credit.

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a. If the investment at issue is equity, the statement must also indicate that such issuance is an original issuance which provides new capital to the qualified business, and that it is not required or subject to an option on the part of the taxpayer to be redeemed by the issuer within five years from the date of issuance.

b. If the investment at issue is subordinated debt, the statement must also indicate that such issuance is an original issuance which provides new capital to the qualified business, and that (i) by its terms requires no repayment of principal for the first three years after issuance; (ii) is not guaranteed by any other person or entity, or secured by any assets of the issuer or any other person or entity; and (iii) is subordinated to all indebtedness and obligations of the issuer to national or state-chartered banking or savings and loan institutions.

23 VAC 10-110-228 Qualified Equity and Subordinated Debt Investments Tax Credit; Tax Credit Application Procedure.

A. Eligible taxpayers who qualify for the equity and subordinated debt investment tax credit must make an application on the Taxpayer Application for the Qualified Equity and Subordinated Debt Investments Tax Credit to the Department of Taxation. For any taxable year that ends after January 1, and on or before December 31 of a calendar year,

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eligible taxpayers must submit an application and supporting documentation requesting the tax credit no later than April 1 of the subsequent calendar year. For example, eligible taxpayers that have taxable years ending after December 31, 2000, and before January 1, 2002, an application and supporting documentation requesting the tax credit must be submitted no later than April 1, 2002.

B. Applications must be made on the form prescribed by the Department of Taxation ~~[,] [and sent by certified mail with a return receipt requested and]~~ postmarked no later than the date specified in this section ~~[, and delivered to an address prescribed by the Department of Taxation]~~.

C. Each taxpayer shall timely supply all information the Department of Taxation deems necessary to properly determine the allowable credit amount. Such information shall include, but shall not be limited to, the following:

1. A copy of the statement issued by the qualified business pursuant to section 23 VAC 10-110-227 D.

2. The taxable year during which the qualified investment was made.

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3. The name, address, federal identification number, and Virginia account number of the taxpayer.

4. A certification by the taxpayer, under penalty of perjury, that the qualified investment meets all conditions outlined in § 58.1-339.4 of the Code of Virginia and these regulations.

5. In the case of a partnership, electing small business corporation (S corporation), or limited liability company, the application shall include the name, address, and social security number of each of its individual partners, shareholders, or members, and a statement as to how any allowable credit shall be distributed to each of its individual partners, shareholders, or members. Notification of the allowable credit amount shall be sent to the entity, and a copy of such notification shall be attached to each individual taxpayer's Virginia income tax return on which the credit is claimed.

D. The Department of Taxation shall review all applications for completeness and notify taxpayers of any errors no later than June 1. Taxpayers must fully respond to any such notices no later than June 15.

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E. All eligible taxpayers shall be notified by June 30 as to the amount of applicable tax credit that may be claimed for the taxable year for which the request was made.

1. In the case of a partnership, electing small business corporation (S corporation), or limited liability company, notification of the allowable credit amount shall be sent to the entity, and such notification shall be included with each individual taxpayer's Virginia income tax return on which the credit is claimed.

2. ~~[Each S corporation shall attach to its annual income tax return, when filed, a schedule listing the name, address, social security number, and allocable credit amount for each of its individual shareholders.]~~

3.] Each [S corporation,] partnership and limited liability company shall provide a schedule listing the name, address, social security number, and allocable credit amount for each of its individual [shareholders,] partners or members to the Department of Taxation within 60 days of the Department of Taxation's notice certifying the amount of allowable credit.

F. Eligible taxpayers who will not receive the final certification of their credits prior to the due date of their individual state income tax returns must either file the appropriate

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return extension request or file their income tax return by the due date, and then amend their return after receiving a credit certification. Amended returns to claim the tax credit must be filed within the applicable statute of limitations.

23 VAC 10-110-229 Qualified Equity and Subordinated Debt Investments Tax Credit;  
Required Equity and Subordinated Debt Investment Holding Period.

A. Equity received in connection with a qualified business investment must be held by the taxpayer for at least five full calendar years following the calendar year for which a tax credit for a qualified investment is earned except in any of the following instances: (i) the liquidation of the qualified business issuing such equity, (ii) the merger, consolidation or other acquisition of such business with or by a party not affiliated with such business, or (iii) the death of the taxpayer.

B. The five-calendar year holding period is to be distinguished from the redemption period (five years from the date of issuance) during which an equity investment cannot be required, or be subject to an option on the part of the taxpayer, to be redeemed by the issuer. The redemption period requirement must be met in order to qualify an equity investment for credit eligibility. The five-calendar year holding period must be met in order to avoid recapture of the credit.

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C. A subordinated debt instrument received in connection with a qualified business investment must be held by the taxpayer for at least three years after the date of issuance except in any of the following instances: (i) the liquidation of the qualified business issuing such subordinated debt, (ii) the merger, consolidation or other acquisition of such business with or by a party not affiliated with such business, or (iii) the death of the taxpayer.

D. The holding period of a subordinated debt instrument received in connection with a qualified business investment that is convertible into equity may be effected by the date it is converted. If such subordinated debt is held for at least three years after the date of issuance, the holding period will be deemed to have been satisfied and equity resulting from a subsequent conversion would not be subject any holding period. If such subordinated debt is converted within three years after the date of issuance, the equity must be held for at least five calendar years following the calendar year in which the subordinated debt was issued. Conversion of such subordinated debt within three years after the date of issuance would not be considered repayment of principal.

E.] If the holding period requirement for the equity or subordinated debt is not met, the taxpayer shall immediately notify the Department of Taxation of such failure and forfeit all used and unused tax credits. The notice of failure to meet the statutory requirements

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shall specify the aggregated credits claimed to date. The notice shall be deemed a tax assessment, to which the Department of Taxation shall add a penalty equal to the amount of the forfeit credits. In addition thereto, interest on the tax assessment and penalty shall be assessed at the rate of one percent per month, compounded monthly, from the date the tax credits were claimed by the taxpayer.

[E. F.] Upon written request, the Department of Taxation shall have the discretion to abate any assessed penalty, in full or in part, if the taxpayer establishes reasonable cause for the failure to hold such equity [or subordinated debt] for the [required five-calendar year ] holding period. The reason for any such abatement shall be preserved among the records of the Department of Taxation.

I certify that this regulation is full, true, and correctly dated.

\_\_\_\_\_  
Danny M. Payne  
Tax Commissioner  
Department of Taxation

\_\_\_\_\_  
Date: